

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Great Northern Utilities, Inc.	:		
	:		
Proposed general increase in water rates. (Tariffs filed on December 22, 2010)	:	11-0059	REHEARING
	:		
Camelot Utilities, Inc.	:		
	:		
Proposed general increase in water and sewer rates. (Tariffs filed December 30, 2010)	:	11-0141	REHEARING
	:		
Lake Holiday Utilities Corporation	:		
	:		
Proposed general increase in water rates. (Tariffs filed December 30, 2010)	:	11-0142 (Cons.)	REHEARING

DIRECT TESTIMONY OF MICHAEL L. BROSCHE

ON BEHALF OF

PEOPLE OF THE STATE OF ILLINOIS

AG EXHIBIT 2.0 ON REHEARING

DATED FEBRUARY 10, 2012

DIRECT TESTIMONY OF MICHAEL L. BROSCH

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I. INTRODUCTION / SUMMARY

1 **Q. Please state your name and business address.**

2 A. My name is Michael L. Brosch. My business address is PO Box 481934, Kansas
3 City, Missouri 64148-1934.

4
5 **Q. By whom are you employed and in what capacity?**

6 A. I am a principal in the firm Utilitech, Inc., a consulting firm engaged primarily in
7 utility rate and regulation work. The firm's business and my responsibilities are
8 related to regulatory projects for utility regulation clients. These services include
9 rate case reviews, cost of service analyses, jurisdictional and class cost allocations,
10 financial studies, rate design analyses, utility reorganization analyses and focused
11 investigations related to utility operations and ratemaking issues.

12 **Q. On whose behalf are you appearing in this proceeding?**

13 A. I am appearing on behalf of the People of the State of Illinois represented by the
14 Attorney General, ("Attorney General" or "AG").

15 **Q. Will you summarize your educational background and professional experience**
16 **in the field of utility regulation?**

17 A. AG Exhibit No. 2.1 Rhg is a summary of my education and professional
18 qualifications. I have testified before utility regulatory agencies in Arizona,
19 Arkansas, California, Florida, Hawaii, Illinois, Indiana, Iowa, Kansas, Michigan,
20 Missouri, New Mexico, Ohio, Oklahoma, Texas, Utah, Washington, and Wisconsin
21 in regulatory proceedings involving electric, gas, telephone, water, sewer, transit,
22 and steam utilities. In Illinois, I have testified in several major proceedings before
23 the Illinois Commerce Commission ("the Commission"). These include Peoples

Gas rate cases in Docket Nos. 90-0007 and 07-0241, North Shore Gas Company
Docket No. 92-0242, Illinois Bell Telephone Company in Docket Nos. 92-0448 and
92-0239, Commonwealth Edison Docket Nos. 07-0566 and 10-0467 and Ameren
Illinois Utilities Docket Nos. 07-0585 through 07-0590. I also testified in ComEd
Docket No. 09-0263 involving the Advanced Metering Infrastructure Pilot Program
and Associated Tariffs, in Docket No. 10-0527 regarding a proposal for alternative
regulation and in Docket No. 11-0721 regarding formula rate regulation. With
respect to Utilities, Inc. rate cases, I sponsored testimony in the pending rate cases
of Charmar Water Company, Cherry Hill Water Company, Clarendon Water
Company, Killarney Water Company, Ferson Creek Utilities Company and Harbor
Ridge Utilities, Inc., in ICC Docket Nos. 11-0561 through 11-0566 consolidated.

Q. Have you previously participated in utility regulatory proceedings in other states?

A. Yes. I have participated in many other utility regulatory proceedings, as listed and described in AG Exhibit No. 2.2 Rhg.

Q. What is the purpose of your testimony in this docket?

A. I was asked to present testimony in response to the Commission's decision to reconsider the rates of the three small water and sewer utilities that are the subject of this consolidated docket. In its final order, the Commission approved the following revenue increases:

- | | |
|--|---------------------------------|
| (1) Great Northern Utilities, Inc. | 254% increase in water revenues |
| (2) Camelot Utilities, Inc. | 215% increase in water revenues |
| (3) Camelot Utilities, Inc. | 89% increase in sewer revenues |
| (4) Lake Holiday Utilities Corporation | 50% increase in water revenues. |

See Final Order, Apps. A, B, C, and D. The Commission granted rehearing on “the Mitigation of Rate Shock Issue” raised by the Camelot Homeowners’ Association and the People of the State of Illinois.

Q. What is the subject of your testimony?

A. I offer a method to alleviate the rate shock that led the Commission to grant rehearing. Specifically, I will present a method to phase-in the authorized rate increases. The magnitude of the approved increases is unusually great, requiring a phase-in approach to enable consumers to accommodate and accept the much higher revenue levels that have been found to be needed. Moderation of rate shock is also beneficial to the utilities, by reducing the risk that ratepayers will dramatically alter their usage levels in reaction to extreme price changes, which could in turn significantly destabilize the future revenues and earnings of the utilities when volumetric rates fail to produce intended revenue levels.

Q. What is the significance of the fact that these utilities have not sought an increase for several years?

A. I understand that Great Northern’s last rate increase was in 1998, Camelot’s last increase was in 1993, and Lake Holiday’s last increase was in 1993.¹ Although ratepayers may know what they currently pay for utility service, they cannot be expected to consider any hypothetically higher utility bills they could be paying today if there had been a different history of rate case filing dates in the past. For instance, I doubt that a ratepayer will be more accepting of a much higher water or sewer bill next month because of any understanding that the bill may hypothetically have been higher last month or last year. Ratepayers do not inherently “owe” the

71 Companies higher rates in the future because of past decisions of management to
72 forego revenue increases that were needed. On the contrary, consumers are entitled
73 to rely on some stability and predictability in the rates established by the
74 Commission that they are routinely billed pursuant to tariff.

75
76 Although there have been many years between rate cases, the Companies'
77 management controls when to seek a rate increase. Consumers and the Commission
78 are entitled to assume that the existing rates and revenues are sufficient and that the
79 Companies have been able to maintain adequate access to capital at the rates then
80 charged unless and until management decides a rate case is needed. In fact, the
81 record in this docket indicates that Utilities, Inc. invested substantial amounts of
82 new capital into these businesses in the years leading up to the rate filings.

83 **Q. Is it significant that the Companies maintained adequate access to capital in**
84 **the period between their last rate increase requests in the 1990s and today?**

85 A. Yes. A key premise of utility ratemaking is the need to assure that utilities have
86 access to the capital markets on reasonable terms to fund infrastructure investments.
87 Each of these Companies is a subsidiary of a larger company, Utilities, Inc. ("UI"),
88 which manages the utilities' new capital investments and ongoing operations.² UI
89 managed these Companies at their prior revenue levels for many years and made
90 major investments in plant during that time, implying that existing revenue levels
91 were adequate to meet overall costs, in some cases for almost twenty years.

¹ ICC Docket 11-0059 cons., Order at 3 (Nov. 8, 2011).

² See testimony of Bruce Haas, Transcript at 41-41.

92 **Q. Are you recommending any ratemaking adjustments in this rehearing**
93 **testimony?**

94 A. No. I understand that the Commission has declined to revisit the revenue
95 requirement set by the Commission in its November 8, 2011 order in this docket.
96 My recommendations instead address the design of rates using a phase-in approach
97 that is reasonable from the perspective of customers and, at the same time,
98 compensatory to Utilities, Inc. investors.

99

100 **II. RATE INCREASES / PHASE-IN RECOMMENDATION.**

101 **Q. Please summarize the revenue changes that have been approved for these**
102 **Companies.**

103 A. The Commission has approved very large percentage revenue changes in these
104 consolidated Dockets. Across the three companies, one of which includes both
105 water and sewer rate increases, the revenue increases are as follows:

106 Table 1:

Final Order Amounts	Present Revenue	Revenue Increase	Proposed Revenue	% Change
Great Northern Water	90,962	231,287	322,249	254%
Camelot Water	75,339	162,124	237,463	215%
Camelot Sewer	106,044	94,259	200,303	89%
Lake Holiday Water	443,578	219,616	663,194	50%

107

108 Source: Appendices A, B, C, and D to Final Order (Nov. 8, 2011).

109 **Q. Under the Companies' proposed rate design, how are residential customers'**
110 **monthly bills impacted by the proposed revenue increases?**

111 A. Residential average monthly bills would be dramatically impacted, as summarized
112 in the following table, if the Companies' proposed level of rates is approved:

113 Table 2:

Bill Impacts	Present Bill	Increase	Proposed Bill	% Change
Great Northern Water	\$ 21.02	\$ 53.45	\$ 74.47	254%
Camelot Water	\$ 28.76	\$ 61.34	\$ 90.10	213%
Camelot Sewer	\$ 41.00	\$ 36.22	\$ 77.22	88%
Lake Holiday Water	\$ 18.49	\$ 7.65	\$ 26.14	41%

114 Source: Companies' Responses to ALJ's Post-Record Data Request, September 29, 2011
115 and October 5, 2011.

116
117 I agree with the Commission that these increases require the adoption of strategies
118 to alleviate rate shock.³

119 **Q. What is rate shock?**

120 A. Rate shock refers to the impact on ratepayers of abrupt and large changes in what
121 are normally expected to be stable and predictable recurring monthly charges for
122 essential utility services. Large increases in monthly bills for water or sewer utility
123 service can cause extreme hardship for utility consumers, particularly those with
124 limited or fixed incomes. Water and sewer ratepayers who are accustomed to
125 charges of \$15 to \$30 per month for utility services experience significant pressure
126 upon household budgets if their water and sewer charges suddenly increase to close
127 to \$75.00 per month for Great Northern customers, and more than \$160 per month
128 for Camelot water and sewer customers.

129 **Q. What role does consideration of "rate shock" play in regulatory practice?**

130 A. The "shock" of disruptively large increases in recurring monthly utility charges is
131 generally avoided by regulators whenever possible in order to ensure public access

³ December 21, 2011, Transcript of Bench Session, page 32 & ff.

to essential services and to assure public acceptance of the rates that are approved for utility services, while ensuring a degree of revenue stability for the utility. Rate shock is not frequently an issue for public utilities and their regulators because of the maturity and capital intensive nature of the business, where stable revenues from the sale of monopoly services tend to track closely with the large amounts of embedded capital investment and relatively stable operating expenses that do not fluctuate dramatically from year to year.

Q. Will the proposed rate changes in the UI filings cause rate shock?

A. Yes. In this era of modest annual inflation and a struggling economy, revenue increases of the magnitude approved for the UI Companies are highly unusual. I understand that the testimony of Mr. Roger Colton was submitted by the People of the State of Illinois in the first phase of this docket, where he discussed the financial challenges facing large portions of the American public.

Q. When the Commission establishes utility rates, under its statutory authority, is there any requirement to consider the overall equity and fairness of the rates that are established?

A. I am not an attorney and cannot offer any legal opinion, but am advised by AG counsel that the General Assembly expects the Commission to approve rates that achieve the following overarching purposes:

(220 ILCS 5/1-102) (from Ch. 111 2/3, par. 1-102)

Sec. 1-102. Findings and Intent. The General Assembly finds that the health, welfare and prosperity of all Illinois citizens require the provision of adequate, efficient, reliable, environmentally safe and least-cost public utility services at prices which accurately reflect

the long-term cost of such services and which are equitable to all
citizens. It is therefore declared to be the policy of the State that
public utilities shall continue to be regulated effectively and
comprehensively. It is further declared that the goals and
objectives of such regulation shall be to ensure...”

Then, among the listed goals and objectives is the following:

(d) Equity: the fair treatment of consumers and investors in order that

- (i) the public health, safety and welfare shall be protected;
- (ii) the application of the rates is based on public understandability and acceptance of the reasonableness of the rate structure and level;
- (iii) the cost of supplying public utility services is allocated to those who cause the costs to be incurred;
- (iv) if factors other than cost of service are considered in regulatory decisions, the rationale for these actions is set forth;
- (v) regulation allows for orderly transition periods to accommodate changes in public utility service markets;
- (vi) regulation does not result in undue or sustained adverse impact on utility earnings;
- (vii) the impacts of regulatory actions on all sectors of the State are carefully weighed;
- (viii) the rate for utility services are affordable and therefore preserve the availability of such services to all citizens.

I am concerned with the “public understandability and acceptance” of UI’s
proposed rate changes that triple prior monthly charges to Great Northern and

Camelot water ratepayers, yielding among the highest charges in the State. The proposed rates raise serious concerns regarding affordability and the availability of services to all ratepayers of these UI water and sewer utilities. The suddenness and size of the proposed rate increases undermines this generally accepted ratemaking principle and could also contribute to future revenue instability for the utilities if customers' usage patterns unexpectedly change.

Q. Has the Commission previously approved a rate moderation plan to deal with rate shock considerations?

A. Yes. In Docket No. 06-0411, Commonwealth Edison ("ComEd") filed a Petition for approval of tariffs implementing its proposed Residential Rate Stabilization Program ("RRS Program"), which was designed to phase in, over a three year period, the large rate increase occurring after the end of the mandatory transition period to market-based rates. Under the proposed ComEd program, customers would see an increase in the average annual residential rates per kilowatt-hour that would be capped at 10 percent per year in each of the years 2007, 2008 and 2009 (the "rate caps"). The Commission's Order dated December 20, 2006 approved the ComEd RRS Program in order to "make the transition to higher rates less drastic and sudden," but limited the carrying charges allowed the utility to a 3.25 percent annual rate that was explained as follows:

After all, the shareholders, just like ratepayers, have a very strong interest in the success of a smooth transition from frozen rates to market based rates. ComEd's ratepayers deserve the option to make the transition to higher rates less drastic and sudden and they deserve to do so on terms that are reasonable and fair to them. A zero interest rate for deferrals would certainly achieve that goal but in our opinion such scheme would inappropriately shift too much of the burden to the shareholders. We feel that the midpoint between zero and ComEd's proposed 6.5% is fair to both

shareholders and ratepayers. The Commission believes that a 3.25% rate for deferrals makes the RRS Program a very attractive option for residential customers who will be challenged with an appreciable increase in their electric bills.⁴

Q. What have regulators done in other jurisdictions to combat rate shock?

A. Regulators in other jurisdictions have also required moderation in the size of immediate rate changes to reduce the potential for rate shock. Rate increase “phase-in plans” were relatively common in the 1980’s when large electric utility investments in nuclear and other base-load generating units were included in utility rate base, causing abrupt revenue requirement growth at levels not acceptable to ratepayers.

Q. Are phase-in plans consistent with any general regulatory policies that are routinely employed as part of the rate setting process?

A. Yes. Rate design changes are typically designed with the concept of “gradualism” in mind, so that any dramatically large changes in rates are implemented in stages over an extended period of time, allowing ratepayers to adapt to the changes and make changes in their consumption patterns and/or monthly budgets as necessary. Gradualism is also beneficial to the utility by reducing the frequency and intensity of customer complaints, moderating the exposure to uncollectible accounts, and minimizing the risk of future revenue instability if customers respond to large rate increases by significantly reducing demand for utility services after new rates are set.

Q. Are you proposing a rate phase-in plan for the UI utilities?

⁴ Commonwealth Edison Company, Petition for Approval of Tariffs Implementing ComEd’s Proposed Residential Rate Stabilization Program, Order dated December 20, 2006 in Docket No.06-0641, p. 21.

233 A. Yes. I propose that the rate changes be limited to immediate, and then subsequent
234 annual installment increases, that do not increase average residential monthly bills
235 by more than \$10 per month or 20 percent per year, whichever is higher.

236 **Q. Have you analyzed how these parameters would affect the rates and revenues**
237 **of the three Companies at issue in this Rehearing?**

238 A. Yes. AG Exhibit MLB-2.3 Rhg provides a separate page(s) for each of the
239 Companies, showing my phase-in proposal.

240 **Q. Can you provide an example of how this rate moderation plan would work for**
241 **Great Northern Water customers, where the proposed revenue increase is the**
242 **largest?**

243 A. Yes. The largest percentage revenue and average bill increase is proposed for the
244 Great Northern water customers. Without a rate moderation program, these
245 customers would see their bills rise to an average of \$74.47 per month, which is
246 substantially above the statewide average water bill of other Commission regulated
247 utilities according to the Commission's January 1, 2011 "Actual Rate Structure and
248 Bill Comparison – General Service" report, available on the Commission's web site
249 and attached to AG Ex. 1.0 as Appendix C.⁵ The AG's recommended rate
250 moderation plan would limit the initial, and subsequent annual rate changes, to the
251 greater of \$10.00 or 20% higher monthly bills relative to presently effective rates.

252 Using these limits, the phase-in first year average monthly bill for Great
253 Northern water consumers would be \$31.02 per customer (\$10.00 plus \$21.02).⁶ At
254 the start of year two, rates would again be adjusted upward to produce an average

⁵ AG witness Colton compared 6,000 gallons of water per month, whereas UI's examples for Great Northern use 5,158 gallons per month.

residential monthly bill (at 5,158 gallons) of \$41.02. At the beginning of year three, Great Northern's rates would again be adjusted to produce an average residential customer bill of \$51.02 (\$10 plus \$41.02). In year four, the bill would rise to \$61.22, reflecting 120% of the prior year monthly bill because a 20% bill increase would be larger than \$10.00 per month. From year four to year nine, the rate and average bill would increase by 20% per year to increase the revenue produced through rates and eventually commence recovery of the deferral of expenses after monthly bills exceed the originally targeted \$74.47 increase.

Q. Can you generally describe the operation of your proposal on the other Companies?

A. Yes. At the Commission allowed revenue requirement, the phase-in periods for the Camelot water and sewer increases would be ten years and six years, respectively. The increase for Lake Holiday customers is less than \$10 per month, and would not require any phase-in under my proposed criteria.

Q. Does the length of time since these Companies' last rate case have any significance relative to the required time needed to complete the phase-in takeoff higher rates?

A. The key determinant of the required time to complete the rate phase-in is the size of the rate change and average bill increases requested by the Companies. It is very unusual for a regulated utility to wait thirteen to eighteen years to request revenues increases needed to fund its operations, while allowing costs to accumulate to the point that revenue increases up to 254% were allowed in a single rate case. Had the

⁶ Throughout this discussion, the reference to customer bills is intended to constrain the underlying tariff rate levels to achieve the average bill at average monthly usage levels.

Companies not waited so long to seek revenue increases, the size of each rate request undoubtedly have been smaller as rate and revenues were managed to keep up with gradually changing costs to provide service.

Q. Does your phase-in proposal include a calculation of carrying cost?

A. Yes. The “Summary of Regulatory Asset Account” table on each page of AG Exhibit MLB-2.3 Rhg contains a column captioned, “6.6% Interest” which adds interest on the average net of tax regulatory asset balance containing deferred O&M expenses for which rate recovery has been delayed. If the Commission determines that carrying costs are appropriate in connection with costs deferred to support the phase-in plan, the Company's average cost of long term debt of 6.6 percent is the maximum reasonable rate for this purpose, and a lower rate may be determined to be equitable by the Commission.

Q. What is the purpose of the “ADIT on Deferred O&M” column in the “Summary of Regulatory Asset Account” table on each page of AG Exhibit MLB-2.3 Rhg?

A. The phasing-in of revenue increases implies the delayed cash recovery of the Companies’ operating expenses. This will result in the incurrence of expenses that are income tax deductible in advance of the year(s) when corresponding taxable revenues will be collected. If the Companies are directed to defer operating expenses as part of an approved phase-in plan, accumulated deferred income taxes (“ADIT”) will be recorded to recognize the realization of current income tax deductions for expenses prior to the amortization of such deferred expenses on the books. The tax deferral cash flow savings from this temporary timing difference

should be recognized as a reduction to the regulatory asset deferral balance upon which any allowed interest charges are calculated.

Q. What is planned to occur in connection with the “Final Rate/Bill Level Granted” amounts shown near the bottom of AG Exhibit MLB-2.3 Rhg for each utility?

A. Upon completion of amortization and full recovery of all deferred O&M expenses, rate and customer bill levels would be revised to match the originally approved revenue requirement. This would ensure that no over-recovery of the intended revenue requirement occurs. It is envisioned that compliance tariffs could be designed and submitted with future effective dates for each “step” of the rate changes needed to match the revenue requirement ultimately approved for each Company by the Commission.

Q. In the event one or more of the Companies files for another rate change prior to completion of the phase-in period shown in AG Exhibit MLB-2.3 Rhg, what would happen to the remaining rate increases that had not yet been implemented?

A. All planned phase-in rate changes that were not implemented at the date of a new rate case filing should be cancelled, to be superseded by new rate and revenue levels found reasonable by the Commission in any future rate case proceedings.

Q. Does AG Exhibit MLB-2.3 Rhg show that the phased-in rates make the utility whole for the residual deferred revenues and carrying costs.

A. Yes. For each of the Companies, separate calculations show how the regulatory asset for deferred expenses is accumulated and then fully recovered. The longest recovery period is 10 years for Camelot water, which faces severe rate shock for

324 both water and sewer services, with monthly combined charges exceeding \$160, up
325 from about \$70.00, which is already quite high.

326 **Q. Does your phase-in proposal affect commercial customers?**

327 A. No. Neither Great Northern nor Camelot has commercial customers, and I have not
328 recommended a phase-in for Lake Holiday rates.

329 **Q. Are there public interest criteria that should be applied by the Commission in**
330 **the review of rate mitigation proposals?**

331 A. Yes. It is essential that approved rates meet other public interest criteria, including
332 affordability, customer understanding and acceptance, revenue stability for the
333 utility, attraction of capital on reasonable terms, the promotion of utility operational
334 efficiency, and the rational allocation of economic resources.

335 **Q. Is the phase-in plan that you present capable of satisfying the interests of both**
336 **shareholders and ratepayers in just and reasonable rates that provide a**
337 **reasonable opportunity to earn a fair return on utility investment?**

338 A. Yes. I describe a general price path for average residential customer bill increases
339 limited to the higher of \$10 per month or 20% per year. AG Exhibit MLB-2.3 Rhg
340 presents an illustration of how the proposed general price path can be realized using
341 assumed average bill impacts for the revenue increase that may ultimately be
342 awarded for each utility. I believe that this proposal properly balances ratepayer and
343 Company interests both by gradually increasing rates over time to give consumers
344 time to adjust their usage and spending and by compensating the Companies for the
345 time value of money during the period of deferral.

346 **Q. Do you have an opinion on whether the Commission should give consumers the**
347 **option to pay the full amount of the increase without a phase-in?**

348 A. I neither oppose nor support giving consumers the option of choosing the phase-in
349 plan or choosing the one step rate increase. Although an optional plan would
350 present more complexities, my proposal could work as an optional plan. That said, I
351 would not expect many consumers to elect to pay utility bills that are suddenly
352 among the highest in the state.

353 **Q. Does this conclude your testimony at this time?**

354 A. Yes.